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## Discharge of Indebtedness on FMHA (FSA) Buy-Out?

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# Agricultural Law Digest

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## DISCHARGE OF INDEBTEDNESS ON FMHA (FSA) BUY-OUT?

— by Neil E. Harl\*

Since enactment of the Agricultural Credit Act of 1987,<sup>1</sup> in which Congress instructed the then Farmers Home Administration (now Farm Service Agency) and Farm Credit Services to avoid losses on loans with priority consideration to writing down the loan principal and interest and setting aside debt whenever those procedures would make it possible for a borrower to survive and remain on the farm or ranch, the question has been raised whether the write-down of loan balances produced discharge of indebtedness income.

### Basic options

Under the legislation (which was signed on January 8, 1988), a borrower's loans could be written down to the point that the "net recovery value" of the restructured debt was equal to or greater than the net recovery value of the collateral securing the debt.<sup>2</sup> A new promissory note was executed for each note rescheduled or reamortized. A borrower was required to enter into a shared appreciation agreement for all write-downs involving real properties as collateral.<sup>3</sup>

In the event a feasible debt restructuring plan could not be worked out with FmHA (or FSA), a debtor under the 1987 legislation is permitted to purchase the collateral at its net recovery value if the net recovery value of the secured property exceeds the net recovery value of a restructured loan supported by the debtor's cash flow.<sup>4</sup> Again, the debtor is required to execute a recapture agreement and to agree to pay in full the difference between the net recovery value of the property and the fair market value of the property (as of the date of the agreement) if within ten years the property is conveyed for an amount greater than the net recovery value.<sup>5</sup>

### Tax Court case

On January 31, 2001, the U.S. Tax Court decided a case, *Jelle v. Commissioner*,<sup>6</sup> focusing on whether a buy-back of collateral at its net recovery value produced discharge of indebtedness income. An issue has existed, since enactment of the 1987 legislation, whether the debtor was discharged of liability under both the debt write-down program<sup>7</sup> and the collateral buy-back program.<sup>8</sup>

In *Jelle v. Commissioner*,<sup>9</sup> a couple engaged in dairy farming in Wisconsin was advised by FmHA that they did not qualify for debt write-down but could avoid foreclosure by buying out the collateral (land) at its net recovery value.<sup>10</sup> The taxpayers obtained a bank loan and purchased the collateral for \$92,057 from FmHA. The agency then proceeded to write off the remaining \$177,772.28 of indebtedness.

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**2001 Agricultural Tax and Law Seminars**  
by Dr. Neil Harl and Prof. Roger McEowen

As a condition of the buy-back, the taxpayers entered into a shared appreciation agreement which required repayment on a formula basis if the property were conveyed within 10-years.<sup>11</sup> The recapture agreement commitment was secured by a secondary lien on the land. In the year of the buy-back, the Farm Service Agency of the U.S. Department of Agriculture (the successor to FmHA) issued a Form 1099-C showing "amount of debt cancelled" of \$177,772.27.<sup>12</sup> The taxpayers did not report the amount as discharge of indebtedness on their income tax return in the year of the buy-back.

The key issue before the court was whether the recapture agreement continued the taxpayer's obligations to FmHA/FSA in a manner that there was no discharge of indebtedness in the year of the buy-back of collateral. As the court noted, the disagreement was over the contingency involved. The taxpayers argued that the cancellation itself was contingent, believing that the transaction merely generated an agreement to cancel their debt at a future time. On the other hand, IRS argued that the transaction involved a present cancellation with a contingent future obligation to pay.<sup>13</sup>

The Tax Court took the position that the taxpayer's indebtedness was discharged in the year of the buy-back of the collateral.<sup>14</sup> The court's reasoning was that "whether or when [the taxpayer] would ever be required to make any further payments to FmHA rested totally within their own control."<sup>15</sup> As the court explained, if the taxpayers chose to sell their property within 10-years, repayment would be required; if the taxpayers chose not to dispose of their property, nothing further would be due.<sup>16</sup>

#### In conclusion

The decision in *Jelle v. Comm'r*<sup>17</sup> is consistent with the IRS position taken in a letter dated May 22, 1989 from IRS to the Farmers Home Administration.<sup>18</sup> In that letter, the Chief Counsel stated "...the Recapture Agreement is not a substitute indebtedness for any of the FmHA debt in excess of the buyout amount. Thus, an FmHA borrower realizes discharge of indebtedness income to the extent the old FmHA debt balance exceeds the buyout amount even when a

Recapture Agreement is part of the restructuring arrangement...."<sup>19</sup>

The IRS position has been that the same result applies to a debt write down.<sup>20</sup> Although *Jelle v. Commissioner*<sup>21</sup> involved only a buy-back at net recovery value,<sup>22</sup> the case provides support for the IRS position on a debt write-down as well.

#### FOOTNOTES

- <sup>1</sup> Pub. L. No. 100-233, Sec. 615, 101 Stat. 1678 (1988), adding I.R.C. § 2001. See generally 5 Harl, *Agricultural Law* § 39.03[3][b] (2001); Harl, *Agricultural Law Manual* §§ 4.02[15][b][ii] (2001).
- <sup>2</sup> See 7 C.F.R. § 1951.909.
- <sup>3</sup> 7 C.F.R. § 1951.909(e)(5). See Harl, "Handling Shared Appreciation Mortgages," 11 *Agric. L. Dig.* 1 (2000).
- <sup>4</sup> 7 C.F.R. § 1951.909(h)(3).
- <sup>5</sup> 7 C.F.R. § 1951.909(h).
- <sup>6</sup> 116 T.C. No. 6 (2001).
- <sup>7</sup> 7 C.F.R. § 1951.909(e).
- <sup>8</sup> 7 C.F.R. § 1951.909(h).
- <sup>9</sup> 116 T.C. No. 6 (2001).
- <sup>10</sup> *Id.*
- <sup>11</sup> *Id.*
- <sup>12</sup> *Id.*
- <sup>13</sup> *Id.*
- <sup>14</sup> *Id.*
- <sup>15</sup> See *Zappo v. Comm'r*, 81 T.C. 77 (1983).
- <sup>16</sup> *Jelle v. Comm'r*, 116 T.C. No. 6 (2001).
- <sup>17</sup> *Id.*
- <sup>18</sup> Letter, Chief Counsel, Internal Revenue Service, to Farmer Program Division, Farmers Home Administration, May 22, 1989, reproduced as Appendix 39C, 5 Harl, *Agricultural Law* (2001).
- <sup>19</sup> *Id.* at 6.
- <sup>20</sup> 7 C.F.R. § 1951.909.
- <sup>21</sup> 116 T.C. No. 6 (2001).
- <sup>22</sup> 7 C.F.R. § 1951.909(h)(3).

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

### BANKRUPTCY

#### GENERAL-ALM § 13.03.\*

**ADMINISTRATIVE CLAIMS.** The debtors had leased farmland from a creditor. The landlords' liens were not perfected and were avoided by the Chapter 7 trustee. However, the debtors used the farms during the bankruptcy case, planting the crops just before filing for bankruptcy and harvesting the crops 142 days later. The landlords filed administrative claims for the rental of the properties during

the bankruptcy case. The Bankruptcy Court had determined the rental value of the properties by multiplying the annual rent by a fraction equal to the number of days the property was used by the bankruptcy estate divided by 365. The appellate court remanded the case because the use of the number 365 failed to take into account the limited use and lower rental value of a farm during nonproductive months. The court noted that, in this case, the bankruptcy estate had the use of the farm during nearly the entire productive period of the farm for the year, from planting to harvest. The court required the fair rental value to be determined by the usefulness of the property during the bankruptcy case. *In re*